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ARIZONA CORPORATION COMMISSION

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March 5, 2004

Commissioner William Mundell
Commissioner Jeff Hatch-Miller
Commissioner Mike Gleason
Commissioner Kris Mayes
Arizona Corporation Commission
1200 W. Washington
Phoenix, Arizona 85007

Arizona Corporation Commission

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In Re: Natural Gas Price Issues in Unisource Energy Services' Territory
Docket Nos. G-01032A-03-0515; G-01032A-02-0598; G-01032A-02-0914;
E-01032C-00-0751; E-01933A-02-0914; E-01032C-02-0914

Dear Colleagues:

I recommend that the Commission address the ongoing concerns over natural gas bills in Unisource Energy Services' territory in three ways:

1. Deal honestly, effectively and wisely with the underlying volatility of natural gas prices. By deferring recovery under the guise of 'protection from volatility', we not only fail to allow price signals to customers (and thus mislead them as to the true cost of gas service) we are also charging future customers for past customer consumption. The deferral implicit in a 'holiday' is, in part, a wager that future gas costs will be less volatile and hopefully lower than past costs. My approach to regulatory certainty is pro-active yet conservative resource planning - distribution companies should engage in forward purchases and protect ratepayers from volatility through the conservative use of options. The Commission should protect ratepayers from volatility via prudent oversight of well-designed adjustor mechanisms. But just as companies should not use options to speculate, the Commission should not use holidays to speculate. In this regard, I propose that the Commission order the following:
 - a. UES should investigate forward purchases of natural gas and where opportunities exist to make purchases below their forward curve forecast, should consider doing so.
 - b. UES should investigate the use of financial derivatives to lock in future gas prices and where opportunities exist to purchase an option that assures prices below their forward curve forecast, or that would reduce implied price volatility below that forecast, should consider doing so.

- i. The Commission should commence a review of its policy on derivatives and hedging – the Commission needs to update its view of options to reflect modern finance theory.
 - c. The Commission should reject ‘holiday’ approaches to dealing with price volatility. 10% of the average customer bill this winter was the direct result of the holiday the Commission adopted in 2002 (\$13.63 of \$131.41). Adding an additional 10% (or more) to next year’s bill in exchange for the illusory benefit of ‘relief’ *after* customers have already borne the brunt of the shock is offering thin salve for their wounds while at the same time condemning them in 2005 to a replay of the shock of this winter’s bills.
2. Leave the surcharge level affirmed in Decision No. 66028 (\$0.15/per therm) in place so that the surcharge will disappear by November 2004. UES customers should not endure abnormally high bills next winter. Staff projections indicate that next winter’s average customer bill will be higher if we *cut* the surcharge than if we continue to recover during the upcoming non-peak season.
 3. Lower the circuit breaker to 125% of normal consumption for March and April bills, and all future winter bills (November through April). This would achieve the objective of ensuring that customers using natural gas to stay warm during the winter do not have to deal with the compounding effect of the surcharge while also ensuring that customers using gas to heat Jacuzzis and pools in the summer do not get a ‘free ride’. The circuit breaker has already deferred approximately 6.25% of the PGA balance (+/- \$500,000 of \$8,000,000) – this does increase carrying costs since the PGA balance receives an interest rate of approximately 1.25% per year and that will tend to increase the time required to recover the PGA balance. However, I believe that by lowering the circuit breaker to 125% for winter bills while at the same time eliminating the circuit breaker for summer bills, the projected recovery of the PGA will be very nearly the same as if the Commission made no change, i.e., removal of the surcharge in November.

The Company and Staff should jointly develop a recommended notice that explains our decision in this matter and present it to the Commission no later than March 31.

Very truly yours,



Marc Spitzer
Chairman

cc: Docket Control
All parties on Record